Excerpts Relevant to

Issue of Predatory Lending from

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Board of Governors of the Federal Reserve System
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Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act

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Chapter 6. The Need for Additional Substantive Consumer Protection

Should Additional Substantive Consumer Protections be Added to the Statutes?

Abusive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections. Previous chapters of this report focus on the benefits of simpler, earlier cost disclosures that will help many consumers comparison shop to avoid the most expensive loans. However, improved disclosures may not aid comparison shopping significantly in underserved markets where there is less competition. In addition, it is unlikely that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and abusive practices.

The Board and HUD believe that substantive protections dealing with predatory lending practices are necessary to ensure that all consumers benefit from reform of TILA and RESPA. The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. However, any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action.

This report discusses three primary areas where legislative efforts might be focused:

- Addressing specific abuses or practices through precisely tailored rules (for example, by amendments to HOEPA).

- Enhancing private remedies and public law enforcement.

- Improving the information available to consumers so they can better weigh risks and costs, make more informed decisions, and avoid unwarranted foreclosures.

A. Background and Overview

1. The Agencies' Objectives. The fundamental issue is determining what degree of government involvement is appropriate in regulating home-equity credit markets. Markets operate more efficiently when consumers are well informed; and improved disclosures assist in that process. Additional counseling or education to aid consumers' understanding would also be beneficial. However, by themselves these improvements will not eliminate the problems created by unprincipled creditors or mortgage brokers that use fraud or deception.

Consumers who replace unsecured credit with home-secured loans place their homes at risk in the event of default. In return, they may benefit financially by replacing significant amounts of high-rate, unsecured debt with lower-rate home-secured credit. Even consumers who cannot qualify for the lowest mortgage rates may benefit, and they may obtain a more favorable tax treatment of borrowing costs. The problem arises when consumers are pressured unfairly or deceptively into entering these transactions, later to discover that the promised benefits were illusory.

In considering options for reform, it is essential to recognize that any regulatory scheme involves trade-offs. Government-imposed rules dictating when and on what terms consumers can obtain credit sometimes raise issues of fairness and economic efficiency. Legislative rules tend to be less flexible and to allocate credit less efficiently. Caution should be taken not to enact broad rules that unnecessarily burden the entire home-equity credit industry in an effort to regulate the few unethical or dishonest players. The desirability of a rule that narrows a consumer's options depends on the circumstances or the perspective of the particular consumer. Preserving consumers' ability to choose loan products that meet their particular needs ought to be a significant consideration.

Whatever statutory changes the Congress may enact, there probably will continue to be some creditors and mortgage brokers that will try to take financial advantage of those who are most vulnerable. If undeterred by the existing laws, they may not be deterred by new prohibitions or they may simply devise different schemes. There is no gain from new rules if they are followed only by those creditors and mortgage brokers who have not been causing problems. Accordingly, new rules or remedies should be precisely fashioned to address the specific abusive practices that are of concern. At the same time, the fact that no individual reform can fully eliminate abusive lending should not deter the effort to achieve meaningful progress through incremental improvements.

Legislation should not be the sole focus of the effort to curb abuses. Other ways to deter them should also be considered. A multifaceted approach is likely to be more effective, including stronger government enforcement efforts under the existing laws and educational efforts by the mortgage industry and government. The mortgage industry, working with federal and state regulators, should itself continue to seek practical means to reduce, if not eliminate, abuses in home-equity lending.

2. Protection Afforded by the Home Ownership and Equity Protection Act. While TILA is primarily a disclosure statute, it has always contained substantive consumer protections such as the right to cancel certain home-secured loans. In 1994, the Congress added to TILA's consumer protections by enacting HOEPA, which contains substantive rules aimed at protecting consumers from abusive lending practices.

HOEPA was a legislative response to evidence of abusive practices involving loans to elderly and often unsophisticated homeowners who were encouraged to use the substantial equity in their homes as security for credit. These loans, typically for home repairs or debt consolidation, carried high interest rates and fees and repayment terms the homeowners could not possibly meet. Substantial closing costs and other charges were often added to the loan amount, thereby reducing homeowners' equity and increasing their monthly payment. Frequently, the loans included short-term balloon payments that forced homeowners to refinance the debt. In short, because of the homeowners' equity in the property, the loans were sometimes made without consideration of the borrowers' ability to repay.

The practice of offering high-priced loans to "house-rich but cash-poor" consumers has been referred to as "reverse redlining"--when creditors target low-income communities and elderly homeowners who have traditionally been denied access to mainstream sources of credit. Because competition in these markets is limited, unscrupulous creditors can make loans with interest rates and fees significantly higher than the prevailing market rates. These loans also may contain onerous terms, such as prohibitively high prepayment penalties that discourage refinancing the loan with other creditors on more reasonable terms.

HOEPA seeks to protect these homeowners from loan agreements that are likely to result in default and the loss of their homes, but it does not limit the rates that creditors may charge or prohibit creditors from making high-priced loans. Instead, the act adds a regulatory scheme for high-priced loans that layers new disclosures onto those required in more conventional transactions and prohibits creditors from including certain terms in loan agreements.[82] These changes to TILA were implemented in section 32 of the Board's Regulation Z.[83]

In June 1997, the Board held hearings to assess HOEPA's effectiveness in combatting abusive lending practices. Because compliance with HOEPA did not become mandatory until October 1995, the information available at the June hearings was limited. (See chapter 2 and appendix E.)

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[82] Among the terms that are prohibited are (1) balloon payments in loans with maturities of less than five years, (2) payment schedules that result in negative amortization, (3) higher interest rates upon default, and (4) prepayment penalties in most instances. Creditors are also prohibited from engaging in a pattern or practice of making loans that rely solely on consumers' homes as the source of repayment without considering whether the consumer's income, debt, and employment status would support repayment of the debt.

[83] HOEPA does not apply to home-purchase loans or to open-end lines of credit because the congressional hearings prior to HOEPA's enactment demonstrated little evidence of abusive practices with these types of transactions. Reverse mortgages are also exempt from the HOEPA rules for high-priced loans, but are subject to an alternative disclosure scheme.

*3. **The Current Market for Home-equity Credit**.* Since HOEPA's enactment, the volume of home-equity lending has continued to increase significantly.[84] The capital markets have provided additional funds for home-equity lending (including the subprime lending market) by establishing securitization programs, similar to those that exist for home purchase loans.[85] Some large creditors now securitize nearly all home-equity loans that they originate. Creditors testified at the Board's June 1997 hearings that industrywide, the number of securitized home-equity loans rose from approximately 40 percent of loans originated in 1991 to about 80 percent today.[86]

Some creditors specifically target subprime borrowers--consumers with relatively low incomes, or credit histories that are limited or tarnished. Although these consumers may have difficulty obtaining more traditional financing, creditors in the subprime market will extend credit to them carrying higher interest rates and fees. Because of the higher costs, these subprime loans may be covered by HOEPA, but they do not necessarily involve deceptive or abusive practices. Thus, although HOEPA seeks to regulate abusive lending practices, the act's triggers also bring many legitimate high-priced loans within HOEPA's coverage. Home-equity creditors argue that any new regulatory requirements should focus on specific abuses and not on subprime mortgages in general, because the cost of HOEPA compliance can add regulatory costs to loans that are already high-priced.[87]

Consumer advocates corroborate creditors' statements about the increase in

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[84] It has been estimated that home equity loans outstanding in 1997 totalled $420 billion, compared to $274 billion in 1994. See Glenn B. Canner, Thomas A. Durkin, and Charles A Luckett, *Recent Developments in Home Equity Lending,* 84 Federal Reserve Bulletin 241, 248 (April 1998).

[85] Some creditors point to other factors to explain the rapid rate of expansion in home-equity lending. Specifically, they cite the financial difficulties of the savings and loan industry as the reason for the diminishing availability of consumer loans from traditional banking institutions. As a result, loans made by non-bank creditors became a more significant source of consumer credit. Next, changes in the tax code eliminated consumers' ability to deduct interest payments on consumer loans unless they were home-secured and consumers realized that they could reduce their borrowing costs by replacing existing credit card debt and other unsecured loans with home-secured credit.

[86] Creditors also testified that the potential financial penalties for noncompliance with HOEPA has had a chilling effect on some creditors and investors. In light of subprime creditors' ability to securitize HOEPA loans, it appears that the capital markets as a whole are sufficiently comfortable accepting the potential risk of non-compliance.

[87] Testimony at the Board hearings was mixed on whether the cost of home-equity credit has increased since HOEPA was enacted. Some creditors say that the increase in their compliance cost has driven up the cost of credit for consumers; others say that increased competition and the influx of capital from securitization programs have driven consumer costs down. And some suggest that certain fixed closing costs merely appear high when applied to small loan amounts, compared with similar costs charged for larger home-purchase loans.

competition as more firms enter the subprime lending market.[88] But they do not believe that the increased competition has had the effect of diminishing the problem of "reverse redlining." Consumer advocates contend that creditors' increased profits and interest in this segment of the market suggests that subprime borrowers may be charged disproportionately more than the amounts necessary to cover the higher risk of default.[89]

4. The Continuing Problem of Abusive Lending Practices. Abusive practices in home-equity lending take many forms, but principally fall within two categories. The first category includes the use of blatantly fraudulent or deceptive techniques that may also involve other unlawful acts. These practices occur although they are illegal under existing law and therefore they appear more difficult to curb through legislation. They include: (1) forging signatures or obtaining signatures on blank documents; (2) falsifying loan applicants' income or the appraised value of the property; (3) overcharging consumers with illegitimate fees; (4) selling credit life or disability insurance to consumers who do not qualify for the insurance, or writing policies for amounts that exceed the consumers' indebtedness; (5) fraudulently conveying title in the property to third parties to facilitate the diversion of loan proceeds, and (6) employing bait-and-switch tactics.[90]

In a second category of abuses, various techniques may be used to manipulate a borrower into accepting an exorbitantly-priced or unaffordable loan. The loan documentation might appear on its face to be entirely proper and thus legally enforceable, but the creditor may have engaged in high-pressure sales tactics or misrepresentations that induced consumers to sign documents they did not fully understand for transactions not in their best interest. Creditors sometimes make oral representations about the purported benefits of the transaction that are inconsistent with what is contained in the loan documents. The required disclosures also may be treated in a cursory manner by creditors that discount their significance.

For example, consumers with large credit card balances may seek a home-equity loan to consolidate debts. Consumers enter into these transactions in response to creditors' promises of lower payments or interest rates. But although they may qualify for an

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88 Their clients often report that they obtained credit in response to creditor solicitations or advertisements rather than initiating a search for a home-equity loan.

89 Consumer groups also state that the growth and development of the home-equity lending market is being facilitated by the Congress' decision in 1980 to preempt state usury laws for first-mortgage loans. *See* 12 U.S.C. § 1735f-7a (1994). This has also affected the market for subordinate-lien loans or "second mortgages." Some consumers seeking funds for debt consolidation or home repairs may find that the funds are available only if they refinance their existing first mortgage as part of the same transaction. Structured this way, the new loan is exempt from any interest rate caps imposed by state law, and creditors' charges that are calculated as a percentage of the loan amount will be higher.

90 Consumers Union of the U.S., Inc., Dirty Deeds: Abuses and Fraudulent Practices in California's Home Equity Market (1995).

affordable second mortgage, a predatory lender might pressure them to borrow a larger amount to pay off an existing first mortgage as well, even though the interest rate on the new loan exceeds the interest rate on the existing mortgage. This allows the creditor to assess points and fees based on a larger loan amount.[91]

As a further inducement, creditors may promise that the loan can be refinanced at a lower rate within a short period. But overall, the loan may involve significant transaction costs that do not improve the consumer's financial position. In some cases, the overall transaction may actually result in higher monthly payments because of high closing costs that the consumer must finance. Consumers who subsequently attempt to refinance at a lower interest rate may discover that there is an extreme penalty for prepayment, or that new fees will further reduce equity.

A loan may be structured with low monthly payments that the homeowner can afford, but the payments are too small to fully amortize the principal resulting in a balloon payment at the end of the loan term. When faced with the balloon payment the consumer must ultimately refinance the loan (paying additional fees and closing costs) or face possible default.

In other cases, the monthly payments may not even cover the accrued interest, causing the principal loan balance to increase; this is known as "negative amortization." Although loans covered by HOEPA are precluded from having balloon payments if the loan term is less than five years, and are also prohibited from having payment schedules that result in negative amortization, some abusive loans may fall just below the HOEPA cost triggers. For high-priced loans covered by HOEPA, a predatory lender may schedule balloon payments just beyond the five-year point.

At the Board's June 1997 hearings, consumer advocates reported continued abusive practices in connection with home-equity loans. Consumer groups described many creditor practices that caused consumers' financial status to decline from satisfactory to bad, or from bad to worse. They also expressed concern that, as the total number of subprime loans increases, abusive loans will also increase in absolute numbers.

Mortgage industry representatives acknowledge that abusive practices occur, but they assert that such practices are not widespread in the national mortgage market as a whole and that the vast majority of high-priced loans covered by HOEPA do not end in foreclosure. In their view, providing consumers with more meaningful cost information earlier in the loan

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[91] In addition, any state usury limits would not apply to a first-mortgage loan. State laws restricting other loan terms, such as caps on variable-rate loans may also be preempted for creditors that comply with applicable federal laws and regulations. *See*, e.g., Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3801 (1994).

application process, as discussed in this report, will help consumers to compare loans and to avoid transactions with excessive costs. They believe earlier disclosure should also increase market competition, making creditors less likely to offer loans with excessive rates or fees.

Industry representatives believe that the trend toward securitizing subprime mortgages has served to standardize creditor practices and to limit the opportunity for widespread abuse. Creditors that package and securitize their home-equity loans must comply with a series of representations and warranties. These include creditors' representations that they have complied with strict underwriting guidelines concerning the borrower's ability to repay the loan.[92] Creditors also point out that some abusive practices in connection with mortgage loans are not attributable to creditors, but to the actions of independent loan brokers or home improvement contractors who arrange financing but who are not regulated as creditors under TILA.

Consumer advocates have also expressed concern that simplifying TILA's cost disclosures will make it more difficult for consumers to rescind abusive loans. Because of the difficulty, time, and expense involved in proving that a consumer was the victim of unfair or deceptive practices, consumer advocates have frequently relied on TILA disclosure violations to bring legal actions that will allow their clients to retain their homes or obtain other relief. This is possible because creditors who engage in fraud or abusive practices often lack the necessary technical expertise to fully comply with TILA's requirements. In such cases, the TILA violations may provide consumers with a means of rescinding their loans, recovering any out-of-pocket fees, and avoiding foreclosure on their homes. While acknowledging that the use of TILA to stop foreclosures was not the original intent of the legislation, consumer advocates express concern that this option might be unavailable if TILA disclosures are simplified. They contend that any legislation simplifying TILA-RESPA disclosure requirements must, therefore, include new remedies to deal more directly with abusive practices.

B. Addressing Specific Abuses and Practices by Modifying Home Ownership and Equity Protection Act

Both creditors and consumer groups believe that improvements to HOEPA's substantive protections can and should be made, but their reasons differ. Creditors seek statutory clarification and simplification to ease compliance burdens and reduce the risk of inadvertent noncompliance.[93] Consumer advocates believe that the act, though an important first step, provides inadequate protection for the most vulnerable consumers, and they

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[92] It also has been asserted by some that as government sponsored enterprises, Fannie Mae and Freddie Mac, enter the subprime market, they could establish clear industry standards for subprime mortgage lending as they have for conventional mortgage lending.

[93] The Board's interpretative rulemaking authority is limited under HOEPA. 15 U.S.C. § 1604(a) (1994).

recommend some specific changes. Accordingly, industry and consumer representatives have offered various ideas for strengthening HOEPA while seeking to preserve consumers' credit options.

1. Home Ownership and Equity Protection Act Coverage Issues. Some creditors keep their rates and fees just below HOEPA's cost triggers in order to avoid the act's substantive restrictions. Consumer groups believe that because these are subprime loans that carry relatively high rates and fees, consumers still need to be protected from predatory lenders that structure loans with repayment terms that are unaffordable given the consumer's income.

Consumer advocates suggest that the rate and fee triggers should be lowered to bring more loans within HOEPA's coverage. HUD supports lowering HOEPA triggers as part of a comprehensive approach to address abuses in lending. In addition, consumer advocates suggest adopting additional criteria for determining whether a loan is subject to HOEPA. One option would be to establish a HOEPA trigger based on the ratio of a consumer's total monthly debt payments (including the loan payment) to the consumer's monthly gross income. If a home-equity loan caused the consumer's debt-to-income ratio to exceed a specified amount, HOEPA's protections would apply. For instance, HOEPA's restrictions on prepayment penalties would apply even if the creditor charged interest and fees below HOEPA's cost triggers. This could allow some consumers to refinance their loans on more favorable terms and lower their monthly debt without incurring significant penalties.

Currently, HOEPA applies the same set of requirements to all loans that meet the law's cost triggers. Another option would be to consider a regulatory scheme that uses loan cost and possibly the consumer's debt-to-income ratio to divide HOEPA loans into two categories. For example, loans would not be covered by HOEPA if they have APRs and fees <u>below</u> an initial trigger amount (the current rule) and if the consumer's debt-to-income ratio is at or below a specified level, for example, 45 percent. Loans that have an APR or fees above the initial HOEPA price trigger (which are currently covered) or loans in which the consumer's debt-to-income ratio is above 45 percent would be subject to HOEPA's existing rules and perhaps some additional restrictions. There would be a third tier for loans with APRs or fees above a second, higher-price HOEPA trigger and loans with higher debt-to-income ratios, for example, exceeding 55 percent. These loans would be subject to additional rules designed to prevent the more abusive practices, including loan flipping.[94]

Creditors have some concerns about a regulatory scheme based on debt-to-income

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94 Consumer groups have suggested, among other things: further restricting balloon payments and prepayment penalties; prohibiting creditors from financing any closing costs and adding them to the loan amount; prohibiting loans with a loan-to-value ratio above 80 percent; prohibiting the use of home-equity loans to pay off unsecured debts; and requiring creditors to use the judicial process to foreclose on a property.

ratios. They express some uncertainty about whether they would be able to determine a consumer's debt-to-income ratio with sufficient accuracy. They note that the accuracy depends in part on information supplied to them by the consumer and that the ratio is subject to change between application and loan closing. Although creditors commonly use these ratios in keeping with their underwriting guidelines, that use does not call for the same level of accuracy that would be required to comply with a statutory trigger. They say that it was concerns of this nature that led the Congress to reject the use of a debt-to-income ratio test when HOEPA was enacted.[95]

2. ***Problems with Loan Flipping***. Consumer groups applaud HOEPA's current restrictions on loan terms as an important first step to curb the practice of loan flipping, but note there is ample evidence that the practice continues.

Loan "flipping" or "churning" refers to the frequent refinancing of home-secured loans. It can occur when consumers are unable to make the scheduled payments on their existing loan and are forced to agree to a new loan to avoid default or foreclosure. Some creditors extend credit knowing that the consumers cannot afford the scheduled payments, knowing that the loan will have to be refinanced within a short time. Loan flipping typically provides little economic benefit to the consumer in comparison with its cost, but it provides significant income to the creditor, principally in points and fees charged on the new loan, often coupled with penalties assessed for prepaying the existing loan. Because the costs of the refinancing are usually added to the loan amount, loan flipping typically reduces the homeowner's equity in the property.

Flipping also may occur when a creditor solicits a borrower to refinance a loan by offering additional cash, lower monthly payments, or both. The savings to the consumer may be illusory if lower monthly payments result from a longer amortization period and the total finance charges and APR actually increase.

HOEPA seeks to prevent flipping by prohibiting certain practices and loan terms that may create unaffordable repayment obligations that are likely to require refinancing. For example, HOEPA prohibits home-secured loans that include balloon payments for short-term loans to restrict non-amortizing loans that the consumer cannot afford to repay unless the loan is refinanced. Similarly, the act prohibits using payment schedules that cause the principal loan balance to increase (negative amortization), so that a substantial payment is still due after all scheduled monthly payments are made.

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[95] Traditional purchasers of mortgage loans in the secondary market, such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), generally cap an acceptable debt-to-income ratio at about 38 percent, whereas subprime creditors may accept loan applicants with debt-to-income ratios as high as 60 percent. An earlier version of the HOEPA legislation included a debt-to-income ratio of 60 percent as a trigger.

To curb loan flipping more effectively, consumer advocates believe that additional restrictions for HOEPA loans are necessary that would:

- Prohibit all balloon payments regardless of the loan term.
- Limit the amount of closing costs that can be added to the loan amount to prevent creditors that flip loans from stripping the consumer's equity.
- Reduce consumer costs by limiting the amount of compensation that can be paid to loan brokers.
- Further restrict the use of prepayment penalties to assist consumers who subsequently qualify for lower-cost credit.

At the Board's 1997 HOEPA hearings, two additional rules to curb flipping were suggested: require creditors to prorate the points consumers pay at closing over the life of the loan and require a rebate of any unearned portion if the loan is refinanced by the same creditor, or include the points paid for an existing loan in calculating HOEPA's cost triggers for any refinancing.

a. Balloon Payments. At the Board's HOEPA hearings, differing views were presented about the existing restriction on balloon payments. Most creditors believe a loan with lower monthly payments and a balloon payment can be a useful tool for consumers experiencing cash-flow difficulties or for homeowners who plan to sell the home before the large payment is due. As long as the balloon payment is disclosed, creditors assert that consumers obtaining HOEPA-covered loans should have the same opportunities as other borrowers in structuring their payment streams.

Consumer groups believe balloon payments should be prohibited altogether for HOEPA loans. They question the need for short-term balloon notes with high-priced loans. Consumer advocates say that HOEPA has eliminated some pre-HOEPA practices such as one-year balloon notes, but they criticize the current rule because it allows creditors to make balloon loans that mature in five years. They contend that for HOEPA loans, consumers are just as unlikely to repay or refinance the loan on more affordable terms after five years than they are after two or three years. Alternatively, some consumer advocates suggested allowing balloon payments only when the creditor has agreed in writing to refinance the unpaid balance on comparable or more favorable terms.

On balance, adding restrictions on balloon payments for HOEPA loans seems appropriate considering the repayment abilities of most consumers targeted by HOEPA. Most consumers have to refinance their balloon payment and they incur significant refinancing costs. The benefit of enabling them to avoid refinancing costs generally outweighs the possibility that some consumers will have fewer payment options. Accordingly, extending HOEPA's restrictions on balloon payments beyond the current five year limitation, or prohibiting balloon payments altogether for HOEPA loans (or possibly the highest-priced HOEPA loans), appears to be warranted.

b. Restrictions on Closing Costs. Consumer advocates have testified that homeowners are stripped of their equity when high-priced loans are repeatedly refinanced in conjunction with the charging of high up-front fees that consumers cannot afford to pay at closing and that are, therefore, added to the new loan amount.

Suggestions have been made for removing creditors' incentive to engage in flipping in order to reap up-front profits, for example, by restricting the manner in which the creditors' origination fees and other closing costs are collected in high-priced loans. Rules that narrow consumers' options, however, may not be desirable for everyone. Consumers who experience temporary cash flow difficulties, but who can meet repayment obligations over the long term, may prefer to refinance with lower monthly payments and a balloon note, and may want to draw on the equity in their homes to meet closing costs. Other consumers may prefer, as a matter of choice, to draw on the equity in their homes in order to retain their cash reserves for other obligations that are more difficult to finance. Thus, rules restricting the financing of closing costs may be a necessary protection or an unwarranted limitation, depending on the circumstances and perspective of the particular consumer.

Consumer groups support restrictions on the amount of closing costs that a creditor is permitted to finance as part of the loan amount in HOEPA-covered home-equity loans. Creditors would be limited in their ability to use homeowners' equity as the source for funding excessive up-front fees. Creditors would still have the option of collecting these costs in cash at the closing or building them into higher interest rates.[96] This approach might curb flipping but it might prevent other refinancings as well because some consumers will not have sufficient cash and others may not qualify for monthly payments at a higher interest rate.[97] However, creditors' opportunity to collect up-front fees would be diminished. HUD believes the Congress should regulate the financing of closing costs in HOEPA loans.

3. Prohibiting Loans that Degrade Consumers' Financial Stability. Consumer groups express concern about the manipulation of borrowers into home-equity loans that are

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[96] In the latter case, creditors may impose penalties for prepayment within the first several years to ensure that they recover their transaction costs if loans are pre-paid earlier than expected. If the law were changed to prohibit all prepayment penalties (instead of just prohibiting pre-payment penalties after five years, as the current law does), creditors would not be assured of recovering their costs.

[97] The rule could have mixed consequences. Some consumers might qualify for the higher interest rate but might be deterred by the larger monthly payment; financial pressures might force others into accepting the terms, and they would then face a higher risk of default if their income is adversely affected in the future.

unaffordable. Sometimes creditors anticipate foreclosure or sale of the property and rely on homeowners' equity as the source for repayment of the loan. In other cases, borrowers' income may be misrepresented on the loan application by a loan officer, broker, or home improvement contractor whose chief concern is not repayment ability, but whether there is sufficient equity to allow the up-front charges (including the originator's own fee) to be paid out of the loan proceeds.

Consumer advocates note that, for some consumers, improved disclosures will not prevent these types of abuses effectively. Some consumers, such as elderly homeowners if they are impaired, are particularly vulnerable; so are borrowers who are unsophisticated in their understanding of complex transactions. High-pressure sales tactics and misrepresentations may be used. In short, consumer groups believe that strong legal standards are needed to prevent creditors from making loans that are likely to result in default and foreclosure.

HOEPA prohibits creditors from engaging in a "pattern or practice" of making "hard-equity" mortgage loans; these are loans made in reliance on the value of the consumer's home for repayment even though the creditor is aware that the consumer will be unable to make the scheduled loan payments considering the consumer's income, obligations, and employment status. Consumer advocates report that, despite HOEPA's prohibition, some creditors continue to make loans that consumers cannot afford to repay. In these cases the creditors profit from excessive up-front fees and depend on foreclosure or sale of the property for repayment. Among the clearest cases of abuse are loans made to persons living on fixed incomes where the monthly loan payments approach or even exceed that income; in some cases these borrowers might have qualified for a reverse mortgage that assured them continued possession of their homes for their lifetimes.

To supplement HOEPA's current prohibition against engaging in a pattern or practice of making mortgage loans without regard for the consumer's ability to make the scheduled loan payments, consumer groups support legislation to make the practice illegal in individual cases.[98] Creditors generally agree that no loans should be made with the intent to foreclose or force the sale of the property. On the other hand, some creditors believe that requiring proof of a "pattern or practice" before imposing liability serves a useful purpose and should be retained. They suggest that consumers benefit when underwriting criteria are sufficiently flexible; flexibility allows creditors to consider individual circumstances in judging a consumer's ability to make scheduled loan payments. Creditors say that the

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[98] Consumer advocates also favor additional remedies for noncompliance, such as permitting the consumer to rescind a transaction or allowing a court to reform the obligation so that payments are affordable (including voiding amounts loaned to pay fees retained by the creditor).

"pattern or practice" requirement assures that they will not be penalized if, in isolated cases, consumers are approved for loans that do not satisfy traditional underwriting standards.

As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a "pattern or practice" of making loans without regard to homeowners' income and repayment ability. Thus, the Congress should consider eliminating HOEPA's "pattern or practice" standard, so that individual consumers will have a remedy based solely on their own loans. If the "pattern or practice" requirement is eliminated, creditors should be allowed to accommodate consumers in special circumstances provided that appropriate documentation verifying the circumstances is obtained.

Some consumer groups have also suggested a specific "suitability standard" that would use numerical guidelines to establish presumptions (by statute or regulation) about whether individual loans are affordable. The guidelines would use a consumer's monthly debt-to-income ratio to determine whether a loan is "suitable" for that borrower. Consumers whose loans were found to be unsuitable would be afforded a remedy or creditors might be subject to some form of legislative sanction.[99] For example, in a case where a consumer's debt-to-income ratio is below 50 percent, the loan might be presumed to be suitable, whereas a loan payment that establishes a ratio above 60 percent might be presumed to be unsuitable. In either event, the facts in any individual case could be used to rebut the presumptions. Thus, suitability standards would go well beyond the current framework of HOEPA, which only regulates but does not prohibit the making of any loan.

Mortgage creditors strongly object to the idea of government-imposed "debt ratios" and believe that such standards would be too inflexible. They say that creditors would avoid making loans to consumers with less-than-perfect credit histories if, when a default occurred, a consumer were entitled to contest any foreclosure on the grounds that the loan should not have been made.

4. The Timing and Content of Home Ownership and Equity Protection Act Disclosures. HOEPA's current three-day waiting period--between the delivery of the HOEPA disclosures and loan consummation--seeks to prevent surprises at the closing table due to previously undisclosed costs. Both creditors and consumer advocates believe the rule is unsatisfactory. Consumer groups assert that more time--at least seven to ten days before closing--is needed for consumers to seek advice and perhaps to search for alternative financing. However, their concern would be mitigated if firm cost disclosures are provided

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[99] For example, a creditor might lose its security interest in the home, preventing the possibility of foreclosure. Thus, suitability standards would go further than using a consumer's debt-to-income ratio to determine if HOEPA's regulatory requirements apply to the transaction.

for all loans (not just home-purchase loans) within three days of the consumers' loan application, as suggested in Chapter 5.

Creditors criticize the current three-day waiting period before closing as unnecessary, and observe that few consumers cancel the transaction during that period or use the time to negotiate other terms. Creditors believe that TILA's three-day rescission period after closing is sufficient to protect consumers, and that the combined waiting period of six days for HOEPA loans is excessive. Their concern would be alleviated if the Board's recommendations concerning rescission, discussed in Chapter 4, were adopted; creditors that provided accurate cost disclosures for loans three or more days before closing, including any required HOEPA disclosures, would not be required to provide an additional three-day cooling-off period after the closing.

Concerns were also expressed at the Board's June 1997 hearings about the requirement for redisclosure. HOEPA is designed to provide consumers with basic cost information and an opportunity to consider whether to proceed with the transaction. The redisclosure rule protects consumers from creditors' promising one set of terms and arriving at the loan closing with documents reflecting another. Where significant disparity exists between HOEPA disclosures and the cost disclosed at closing, additional time to consider the new terms seems appropriate.

Creditors reported that loan documents are commonly revised because consumers change their minds about how much money they need for personal use or, in debt consolidation loans, when the number or amount of loan payoffs changes. Creditors state that their frustration and consumers' annoyance is exacerbated when such changes require new HOEPA disclosures and a new three-day waiting period before closing. Creditors asked for some flexibility in the redisclosure requirement, so that a new waiting period would not be required when the change benefits the consumer or is de minimis. Consumer advocates acknowledge that a de minimis rule seems reasonable, but many fear that in the legislative process, and over time, the tolerance would increase beyond an acceptable level.

Creditors have offered a variety of standards that they consider to be de minimis. All agree that an increase in the monthly payment of less than one dollar should be within the tolerance, and no redisclosure or additional delay in closing should be required in that situation. Some creditors suggest that a tolerance of 1 or 2 percent of the amount disclosed be permitted before a new waiting period is imposed. Larger tolerances are more problematic. For example, a 10 percent tolerance would allow an increase in the monthly payment amount from $350 to $385. This may be de minimis to some consumers but not others.

*5. **Rules for Sales of Credit Insurance**.* Consumer groups continue to express concern about the sale of credit insurance (life, disability, and unemployment). If the insurance is optional, creditors need not include charges for credit insurance as part of the disclosed finance charge or the APR, provided that its optional nature and the premium amount are disclosed as required by the regulation. Currently, TILA does not contain any other rules or limitations regarding the sale of credit insurance.

Consumer advocates say that because credit insurance is highly profitable for creditors, consumers are frequently subjected to high-pressure sales tactics at the loan closing, with little opportunity to comparison shop or reflect on the decision. They are especially concerned that consumers targeted by HOEPA are sometimes charged exorbitant premiums that add significantly to the total cost of the transaction. Moreover, because credit insurance costs are not included in calculating whether a loan is covered by HOEPA, a creditor can keep the interest rate and closing fees just below HOEPA's triggers for coverage and still achieve a high return by inflating the cost of credit insurance sold with the loan. The Congress may wish to consider whether it would be appropriate to include these credit insurance premiums in HOEPA's fees-based trigger.

Consumer groups believe that more competitive pricing of credit insurance could be achieved if the insurance were sold after the loan closing. Creditors, on the other hand, believe that consumers should be able to benefit from the convenience of one-stop shopping as long as they receive the required disclosures.

Consumer groups also express concern about the practice of collecting the insurance premiums for the entire loan term in advance. Moreover, these premiums are usually added to the loan amount, which increases the total finance charges paid by the consumer. If the loan is later refinanced or is paid off before maturity, the entire premium will not have been earned, but consumers may not know to seek a rebate, or may not know how to do so. Consumer groups (and many creditor groups) support legislation that would require creditors to collect credit insurance premiums periodically with the consumer's regular mortgage payment for HOEPA loans.

The regulation of insurance, including the allowable premium rates, has historically been a matter for state law. It may be feasible, however, to prevent some abusive practices by regulating the method for collecting credit insurance premiums in connection with HOEPA loans. For such loans, the Congress should consider prohibiting the advance collection of premiums, so that consumers pay periodically--and only for the time the loan is actually outstanding, so that termination of the loan automatically cancels both the coverage and any liability for future payments. If this is done, consumers' need to finance the premiums and add the cost of insurance to the loan amount would be eliminated.

The Congress should also consider whether new legislation is needed to guarantee consumers' right to cancel credit insurance coverage during the life of the loan, or whether adequate protection exists under the state insurance laws. With such a right, consumers pressured into purchasing policies at closing that are not affordable (or not competitively priced) could cancel them and thus lower their monthly payments.[100] In this context it also would be appropriate to consider the need for rules requiring written notice of any rights consumers may have to cancel the coverage and of the steps to follow to exercise those rights.

C. Ensuring Adequate Private Remedies and Public Law Enforcement

Creditors that engage in abusive practices are unlikely to be deterred by additional rules and prohibitions alone. The effectiveness of the law in dealing with abusive practices also depends on adequate enforcement by government agencies and by consumers. The role of the mortgage lending industry and the possibility of self-regulatory action is also important.

1. Enhancing Government Enforcement Efforts. Abusive mortgage loans are not generally a problem among financial institutions that are subject to regular examination by federal and state banking agencies. Abuses occur mainly with mortgage creditors and brokers that are not subject to direct supervision. For most of these entities, enforcement authority under TILA (and other federal consumer protection laws) rests with the Federal Trade Commission. In addition, TILA expressly authorizes state attorneys general to enforce the substantive rules added by HOEPA.[101]

To enhance law enforcement efforts, the number of abusive lending cases investigated and prosecuted should be increased. Supplementing the data available to law enforcement agencies about the practices of non-bank creditors that make subprime loans would be an important first step. In the absence of the type of direct oversight performed by bank examiners, equipping law enforcement agencies with more detailed information would enable them to focus enforcement efforts in a more efficient and effective manner.

One way to do this is to establish a means for monitoring the lending activities of unsupervised creditors that regularly make loans with the greatest potential for abuse. It

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[100] Consumer advocates also report that consumers are sometimes sold unnecessary insurance without their knowing it. For example, a home-secured loan for $50,000 with a 15-year term may require monthly payments of $600, for a total of $108,000 over the life of the loan. Consumer advocates report that some policies and premiums are based on coverage for $108,000, even though the consumer is only liable for the unpaid balance of the $50,000 loan amount. In other cases, they report that creditors falsify insurance applications in order to collect policy premiums even though the consumer may not qualify for the coverage. Although such fraud may be difficult to address through new rules, prohibiting the advance collection of premiums could lessen the economic incentive for creditors, and could make it easier for consumers to cancel the insurance when the abuses are uncovered.

[101] States also enforce their own consumer protection statutes and prosecute cases involving fraud, or may use their licensing authority as a basis for investigating creditor practices.

might entail requiring these creditors to track certain types of loans in order to preserve or record data regarding these transactions. The data could be made available to law enforcement agencies conducting an investigation, or in some instances reported to government authorities on an aggregate basis.[102] The FTC could assist in identifying the particular types of information that would strengthen that agency's investigative efforts.

Additional burdens on broad segments of the mortgage lending industry are not warranted and would only add to the cost of credit. The focus should be on collecting data from unsupervised creditors that offer loans more likely than not to involve abusive practices. For example, creditors that make more than a certain number or dollar-volume of HOEPA loans might be required to keep records showing which transactions involved customers who refinanced within short periods, or which loans were extended to consumers with very high debt-to-income ratios. Requiring these creditors to keep records about loan prices and broker compensation might also enable investigating agencies to identify and target individual cases that deviate most significantly from the prevailing market rates for subprime mortgages.

The ultimate goal is to assist law enforcement agencies in gathering information to identify those creditors or brokers that routinely engage in transactions involving fraud or other illegal practices. A nationwide database covering individuals in the mortgage industry who have been subject to enforcement actions or had their licenses revoked by state regulators might also be created. Concerns for consumer privacy should be addressed, by ensuring that any loan information reported by creditors contains only the minimum amount of personally identifiable information necessary and is available only to the appropriate law enforcement authorities, as is the case with bank examination data gathered by supervisory agencies. HUD supports the development of new recordkeeping and reporting requirements for certain creditors engaged in making HOEPA loans.

2. Additional Consumer Remedies for Unfair or Deceptive Practices. Consumer advocates favor enactment of a broad federal statute applicable to home-secured loans, prohibiting unfair or deceptive acts and practices (referred to as a "UDAP" statute). UDAP statutes that have already been enacted into state law allow consumers to seek redress through private lawsuits if they can show that a particular business practice or transaction was unfair, deceptive, or unconscionable.[103] To obtain relief under a state UDAP statute, consumers typically demonstrate the harmful effects of the transaction; they do not have to prove any

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[102] In this way, covered creditors would operate under increased scrutiny, or otherwise face penalties for failing to comply with the new data collection requirements.

[103] All fifty states and the District of Columbia have enacted at least one such statute, directed at preventing consumer deception and abuse. *See* National Consumer Law Ctr., Unfair and Deceptive Acts and Practices (4th ed. 1997). Many state UDAP statutes cover practices in "trade or commerce" or the "sale of goods and services," but the courts have interpreted them to apply to credit transactions generally, including mortgage transactions. In some states, however, the law does not apply to home-secured loans.

specific intent on the part of the creditor to deceive or defraud the consumer. Proving a violation of a UDAP statue thus would be easier than proving a traditional fraud claim.

Section 5(a) of the Federal Trade Commission Act currently allows the FTC to take legal action against deceptive acts and practices in connection with mortgage loans.[104] It does not, however, give consumers a private right of action. Consumer advocates seek an individual remedy because enforcement actions brought under the FTC Act usually target creditors only after evidence has been collected demonstrating that a pattern or practice of wrongdoing exists. They argue that enacting a federal statute would provide uniform coverage in all states and could declare certain practices unlawful per se, or could define circumstances that create a rebuttable presumption that a transaction was unfair or deceptive. For example, fraudulent practices--such as obtaining signatures on blank documents, backdating documents, or falsifying applicants' income--could be specified in a federal UDAP statute as unlawful practices. A home-secured loan made to a consumer with a debt-to-income ratio exceeding a specified percentage might raise a presumption, subject to rebuttal, that the creditor acted unconscionably by making a loan the consumer could not afford to repay. Consumer representatives also have suggested that where HOEPA already prohibits a particular loan term, a UDAP statute should specify that it is an unfair trade practice for the creditor to attempt to enforce that term.[105]

Creditors are concerned that a federal UDAP statute creating a private right of action would allow lawyers representing consumers with individual complaints to transform those claims into costly class action litigation. There are also questions about the effect that a federal UDAP statute would have on similar state laws. To the extent such laws have overlapping coverage, the legislation might specify whether it intends for consumers to have concurrent remedies or to limit consumers by requiring them to choose between the federal and state remedies. Allowing claims to be resolved in federal court may be unnecessary if there is adequate protection for borrowers under the applicable state law. Accordingly, if a federal UDAP statute is adopted for home-equity loans, the Congress may wish to consider whether it is appropriate to require consumers to utilize their state law remedies where that law is at least as protective of the consumer's rights as the federal statute. HUD believes that the Congress should consider the enactment of such a standard.

3. Ensuring Consumer Rights in Foreclosures. Consumers who have been victims of abusive practices must be provided adequate opportunity to assert their rights in order to avoid unwarranted foreclosures. For the most part, the procedures that a creditor

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[104] 15 U.S.C. § 45(a) (1994).

[105] Consumer advocates also suggest that a creditor's violation of UDAP standards in connection with the making or collecting of a mortgage loan should be a defense to any foreclosure. To the extent that the consumer was liable for the debt, the creditor would lose its security interest in the home and become an unsecured creditor.

must follow for foreclosure are governed by state law, local practice, and the terms of the relevant contract documents. This includes the amount or type of notice that consumers are entitled to receive about an impending foreclosure. Some states require creditors to provide actual notice to the consumer of the foreclosure, but in other states notice by publication is deemed sufficient. In some states a judicial process is followed; the creditor must file a lawsuit and obtain a judgment in order to obtain permission to sell the property. Other states allow the use of a nonjudicial process, where the creditor merely notifies the borrower that the home will be advertised and sold, thereby placing the burden on the homeowner to take legal action to prevent the sale if possible.

Some states afford consumers the right to "cure" a delinquency or default and avoid foreclosure by bringing the obligation current.[106] Even after the time to cure the delinquency has passed, consumers generally have the right to "redeem" the property prior to the foreclosure sale by paying off the full amount of the mortgage plus any fees and expenses related to foreclosure. This is sometimes possible through a refinancing or private sale of the property. A few states even allow redemption of the property after a sale.

Consumer advocates believe that existing state laws do not adequately protect consumers from abusive practices in connection with foreclosures. They support legislation that would grant substantive rights to consumers when their mortgage loans are in default. Specifically, they believe that consumers should have the right to cure their delinquency or default in all cases. Consumer advocates also suggest that a creditor should have some legal duty to agree to a consumer's reasonable request for a modification of the loan terms before being permitted to foreclose.[107]

Consumer groups assert that creditors should be required in all cases to provide consumers with actual written notice of an impending foreclosure. Consumer groups are concerned that even when consumers do receive a notice of foreclosure, they may not get adequate information about the legal options that are available to them under the applicable laws. They state that when some consumers try to exercise their rights, they are unable to obtain accurate, timely information about the amounts they must pay to avoid foreclosure. Accordingly, consumer groups have proposed that consumers be guaranteed the right to terminate any foreclosure proceeding by tendering the amount specified in the creditor's advance notice of foreclosure, even though the creditor may still be able to collect any additional amounts that are due.

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[106] A right to cure the default may be subject to limits on how many times or how often the consumer may exercise the right.

[107] This might be similar to the requirement for creditors to employ foreclosure prevention and loss mitigation strategies for loans insured by HUD.

Some home-equity creditors have voiced support for legislation to provide additional protection for consumers in foreclosure. These creditors propose that consumers be guaranteed the right to receive a notice at least 30 days before foreclosure commences that would explain the foreclosure process. The notice would specify consumers' substantive rights and legal options and include information about the availability of credit counseling. Their proposal would also require creditors to obtain a full appraisal of the property prior to a foreclosure sale in order to ascertain the extent of the homeowner's equity. The purpose of the appraisal would be to determine if the consumer's equity is 20 percent or more of the appraised value; if so, foreclosure would be delayed to allow the consumer to sell the property.

Consumer representatives also believe that allowing foreclosure only by judicial process is important for protecting consumers' interests in the property. They assert that this is particularly important for borrowers who are victimized by unscrupulous home improvement contractors that arrange home-secured financing for the repairs. In these cases, a mortgage may be recorded on a consumer's home even though the home improvements are never completed or have latent material defects. In states where foreclosures do not require judicial process, if a consumer refuses to make payments and is in default, the creditor can commence foreclosure proceedings and shift the burden and expense to the consumer of initiating a legal action in order to assert the contractor's breach as a defense to the foreclosure. Most borrowers are unaware, however, that in such circumstances they may have a valid defense for nonpayment under Federal Trade Commission rules.[108]

Consumer advocates argue that federal law should prohibit nonjudicial foreclosure in home improvement loans. Creditors oppose such a sweeping remedy, but have suggested that additional safeguards are possible, including a requirement for mandatory third-party completion certificates prior to disbursement of funds, and creation of some form of borrower claim process, that would necessitate an independent evaluation and determination of a borrower's claim concerning a contractor's nonperformance before foreclosure could commence.

The Board and HUD support the adoption of certain minimum standards for the notice creditors must provide consumers prior to a home foreclosure. The goal would be to establish procedures that avoid unwarranted foreclosures by maximizing consumers' opportunities to cure a delinquency or arrange other financing. These procedures are especially important where a consumer who is overburdened by an abusive loan can qualify for financing on less onerous terms. The legislation might state that prior to any foreclosure sale, consumers must have first received, in a written notice: (1) an explanation of whatever substantive rights they have under applicable state law to cure the delinquency or redeem the property, and information about how they may do so, including the amounts that must be

[108] 16 C.F.R. § 433 (1997).

paid; (2) an explanation of how the foreclosure will proceed if they do not exercise those rights; (3) an explanation of other rights they may have under any applicable federal mortgage program, such as an FHA or VA program;[109] and (4) information about the availability of third-party credit counseling. In addition, HUD supports new foreclosure prevention strategies, including, as appropriate, pre-foreclosure counseling, new federal rights for borrowers to cure delinquent loans and the right to recover remaining equity through private sale prior to foreclosure.

4. Regulating Creditors' Use of Mandatory Arbitration. Some creditors have incorporated arbitration clauses in their credit agreements as a response to individual and class action lawsuits challenging creditors' practices. Arbitration clauses require consumers to forego judicial remedies and allow a neutral third party to resolve any dispute arising from the transaction. Consumer representatives have expressed concern about this trend, because the clauses typically mandate arbitration at either party's option. They argue that creditors' use of compulsory arbitration clauses negates consumers' ability to enforce their rights under TILA and other consumer protection statutes.

There are material differences between the way lawsuits and arbitrations are conducted. Most notably, arbitrations do not involve a jury and consumers' ability to gather evidence through pretrial discovery is much more limited. Class actions and punitive damage awards usually are not permitted in arbitrations. Consumer advocates argue that these differences make arbitrations more likely to favor creditors.[110] Accordingly, they support legislation to prohibit the use of compulsory arbitration clauses. Creditors assert that these differences are a strong deterrent to the filing of frivolous claims, which they note must sometimes be settled to avoid costly and time-consuming litigation.

Another option would be to enact certain consumer safeguards. For example, creditors might be required to provide consumers with an early disclosure if a mandatory arbitration clause will be used, so that consumers are informed when they are comparison shopping. At the loan closing, creditors that use mandatory arbitration clauses might be required to have consumers sign a separate acknowledgment rather than having arbitration clauses contained within other complex legal documents that consumers may overlook. This

[109] Mortgage loans insured by HUD, the Federal Housing Administration (FHA) and the Veterans' Administration (VA) give borrowers certain rights that may not necessarily apply to conventional loans. For example, with FHA loans, creditors must notify a consumer within two months of a delinquency and make reasonable efforts to interview the consumer before the loan becomes three months in arrears. Foreclosures are governed by certain rules, such as requiring creditors to accept partial payments or prohibiting foreclosures where the delinquency involves only an escrow account. Creditors are also expected to consider whether the specific circumstances qualify for one of the FHA's foreclosure prevention strategies or loss mitigation tools, such as a forbearance agreement, loan modification, or a pre-foreclosure sale.

[110] *See generally*, Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 Ohio St.J. on Disp. Resol. 267 (1995).

would be similar to the separate disclosures for credit insurance sales currently required under TILA. There might also be requirements as to the form and content of creditors' disclosures to ensure that a consumer's agreement to enter into a loan with a mandatory arbitration clause is an informed and meaningful decision. This might include information about the differences between arbitration and a lawsuit, so that consumers are aware of the consequences of waiving their rights to use the judicial process.

5. ***Voluntary Industry Self-Regulation***. Consumer protection might also be enhanced by industry self-regulation. The vast majority of mortgage creditors and brokers do not engage in abusive lending. The creation of a voluntary, self-regulatory organization that would offer membership to any creditor or broker that agrees to abide by established ethical standards and rules of conduct would undoubtedly benefit both consumers and legitimate creditors. Creditors that elect to become members and follow these rules would have the ability to use their membership as a marketing tool to gain competitive advantage. Those creditors that do not satisfy membership requirements would risk additional scrutiny from law enforcement agencies, the media, and others.

The success of this effort would depend on the commitment of the organization and its members to informing and educating consumers about its significance. This could include warnings about the need to be wary of firms or individuals that are unwilling to abide by the type of rules adopted by the organization. In addition, such an organization might require its members to provide consumers, by contract, with the option of filing and settling any grievances before a quasi-judicial body established by the organization. This might be particularly useful for consumers needing to resolve minor disputes.

D. Improving the Information Available to Consumers Through Counseling

Consumers who obtain pre-transaction counseling may be less likely to enter into mortgage loans that are not viable in the long run based on their economic circumstances and this may avoid some unwarranted foreclosures. Currently, pre-loan counseling is required under federal law before certain extensions of credit are made, such as reverse mortgages guaranteed by HUD under its Home Equity Conversion Mortgage program, because these transactions are complicated and riskier than conventional mortgages. In other situations, such as default on an FHA-insured loan, consumers are merely provided with information on the availability of HUD-approved counselors, but they are not required to consult one; the consumer ultimately decides whether such counseling is needed. Either approach could be expanded and coupled with consumer education.[111] To be effective, however, there must be

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[111] Currently, HUD helps provide funding and training for a nationwide network of independent counseling agencies that provide consumers with information on a variety of topics. For example, under HUD's reverse mortgage loan program, consumers must complete a counseling session which includes information on topics such as the financial implications of entering into a reverse mortgage, possible tax implications, and the availability of other financing methods.

adequate resources dedicated to this purpose, to expand and improve on the existing base of housing counselors.

Good faith efforts to prevent foreclosures are in the best interests of both creditors and consumers. HUD uses counseling as a technique for curing delinquencies on mortgages insured by HUD or the FHA. HUD expects creditors for insured loans to consider the circumstances of each case and execute a plan that promotes foreclosure alternatives and mitigates the potential financial loss that is likely to result. Foreclosure alternatives include the use of forbearance agreements, loan modifications, pre-foreclosure sales, or conveyance of a deed in lieu of foreclosure. HUD requires creditors on insured mortgages to refer homeowners to a qualified, HUD-approved, housing counseling agency early in the default period to clarify the various alternatives available to homeowners and to reduce delays in obtaining assistance. Based on its experience in this area HUD continues to support default counseling.

Consumer representatives support an expanded role for homeowner counseling. Some have proposed that creditors make pre-loan counseling by third-parties available at no cost to consumers, as a means to keep consumers from entering into abusive or problematic loans. They also support making counseling more widely available to homeowners who are in default, even when the loan is not federally insured. As industry representatives note, however, any requirement that counseling be provided to consumers raises the fundamental issue about how the additional costs would be funded.

The initial focus of reform should center on increasing consumer counseling in situations that pose the highest risk to consumers. Homebuyers have varying degrees of experience. Although first-time homebuyers have a greater need for counseling, the need for routine pre-loan counseling for all first-time homebuyers has not been demonstrated and such wide-scale efforts are not likely to be cost effective.

As a general matter, whether to seek pre-loan counseling in routine cases could be left to the discretion of the consumer. There are particular types of loans, however, that are inherently complex or risky. In such cases, the benefits of pre-loan counseling might outweigh any additional costs, which might be reflected in the price of the loan product. Another approach could be adopted requiring counseling before a consumer obtains a HOEPA loan. Yet another approach might be to require counseling before a consumer refinances any loan that was obtained within the previous twelve months, or where the consumer's debt-to-income ratio exceeds a specified level. A more limited approach would be to provide notice about the availability of counseling and how to locate these services before consumers enter into transactions such as HOEPA loans or first-time home purchases.

HUD supports the approach of requiring pre-transaction counseling for HOEPA borrowers, where appropriate.

In addition, greater effort should be made to ensure that consumers who are delinquent or in default on their mortgage loans are adequately informed about counseling resources that may be available to them. This might prevent some unwarranted foreclosures. For mortgages insured by HUD this information is already provided, and HUD-approved housing counselors are available to assist these consumers. Creditors are required to notify consumers about the availability of counseling within a fixed period after the consumer's default and before foreclosure.

E. Recommendation

The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. These protections should be included as part of any legislation enacted to simplify and reform TILA and RESPA to ensure that all homeowners benefit from the statutory reform. The report discusses three primary areas where legislative efforts might be focused: addressing specific abusive lending practices; enhancing private remedies and public law enforcement, and; improving the information available to consumers. Any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action.

The Board and HUD specifically recommend:

- Extending HOEPA's restrictions on balloon payments beyond the current limitations or prohibiting them altogether for HOEPA loans (or possibly the highest-priced HOEPA loans);

- Prohibiting the advance collection of lump-sum credit insurance premiums for HOEPA loans, so that consumers may pay premiums periodically with their regular mortgage payments and termination of the loan automatically cancels both the coverage and any liability for future payments; and

- Requiring certain minimum standards for the notice creditors must provide in home foreclosures, including a written notice explaining consumers' legal rights and how they may avoid foreclosure, the process that will be followed if they do not exercise those rights, and information about the availability of third-party credit counseling.

In addition, HUD recommends:

- Lowering HOEPA thresholds combined with prohibitions against loan flipping and other specific abusive practices including such measures as regulating the financing of closing costs, requiring creditors to take into account the consumer's capacity to repay, expanding the current restrictions on prepayment penalties, and providing new protections for home improvement borrowers claiming contractor nonperformance or malfeasance;

- Adopting new foreclosure prevention strategies that, where appropriate, include pre-foreclosure counseling and establish new federal rights for consumers to cure delinquent loans and recover remaining equity through a private sale prior to foreclosure;

- Requiring pre-transaction counseling, where appropriate, for vulnerable HOEPA borrowers;

- Imposing information collection and reporting requirements on certain creditors that make loans covered by HOEPA; and

- That the Congress consider establishing a federal "unfair and deceptive acts and practices" standard to provide a private remedy for transactions that are unfair or unconscionable.

Chapter 7. Additional Reform Issues

This chapter first discusses the need for consumer education in order for consumers to fully benefit from TILA and RESPA reform. The chapter then discusses the agencies' recommendations for harmonizing RESPA's and TILA's coverage of transactions and parties. Finally, it addresses remedies under RESPA including several recommendations for enhancements.

Consumer Education

Mortgage loans are inherently complicated, and the process has become even more so as the variety of available loan products has multiplied. Informed consumers are likely to make better decisions. However, because most consumers are not likely to need or shop for a mortgage more than a few times during their lives, they have limited opportunities to master the technical details of these transactions. Consequently, it is important to provide educational materials at the time they will be most useful, when consumers are directly focused on purchasing or refinancing their homes.

Increased efforts by industry and community groups to educate consumers could have a significant impact. New educational materials or other tools, including videotapes and computer programs, could be developed and widely distributed with the aid of the electronic mass media. This might be undertaken by the mortgage industry in conjunction with consumer and community organizations. Distributing written materials at the point of service may continue to be the most effective means for reaching some consumers, particularly lower-income individuals who in the past have been targeted for abusive loans.

The use of home computers to access the Internet and communicate with financial service providers has already changed the way many consumers obtain information and shop for mortgages. As personal computers become even more affordable and more common in homes, schools, and public libraries, more consumers will obtain information in this manner. The innovative use of technology to reach consumers should also be explored. For example, electronic kiosks at creditors' retail locations or other public places might bring information resources to those who do not have similar private access. Also, electronic information might be provided to some consumers through third parties, such as credit counselors or civic organizations.

1. Educating Consumers about Cost Disclosures. A commitment to educating consumers about any new disclosure scheme is vital to the success of the reform effort. Consumers will not fully benefit from TILA and RESPA reform and simplified, earlier cost disclosures unless they understand key information presented in the disclosures. In particular, consumers must understand the uses of the APR and the two disclosure approaches--guaranteed and estimated settlement costs--for purposes of shopping and negotiating loan terms.

For example, RESPA currently requires HUD to prepare and distribute a Special Information Booklet to help homebuyers understand the nature and costs of real estate settlement services. The booklet could be revised to incorporate information about the TILA cost disclosures as well, including a worksheet that consumers could complete to compare loans as they shop. Consumers could calculate the cost of the loans for different durations, or evaluate the effect of points, to determine which loan is best for them considering individual factors such as available cash or their anticipated length of stay in the home. Anecdotal evidence indicates that consumers find the Special Information Booklet informative; if revised, it must remain brief and user-friendly to be effective.

HUD's Special Information Booklets must be provided to consumers within three days after loan application for home purchase transactions.[112] The Special Information Booklet could be required to be provided at the time of application instead of within three days.[113] If this is done, the timing would be consistent with the current requirement under TILA that booklets describing adjustable rate mortgage loans and open-end home-secured lines of credit be given at application. This would simplify compliance for creditors by having the same timeframe for all three booklets and would provide educational material to consumers earlier. HUD's booklet for home purchasers could also be offered or given to consumers even before a loan application, such as when the consumer first contacts a creditor or establishes a contractual relationship with a realtor, or other settlement service provider.

2. Education to Avoid Abusive Loans. Education is also important to deter abusive loan practices. Consumers might be better informed and possibly avoid some abusive loans if comparison shopping were made easier. Simplifying and improving TILA disclosures will help, but educating consumers about home-equity loans in particular is also critical. Educational materials should include information about consumers' rights under the laws' substantive protections.

Consumers who obtain information from a variety of sources, either by comparison shopping or by consulting public information resources or counselors, are less likely to become victims of abuse. Consideration should be given to how to increase the public's awareness of this fact, and how to facilitate consumers' ability to gather relevant information. HUD's Special Information Booklet for home purchase loans can also serve as

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[112] The Special Information Booklet, which is entitled "Buying Your Home: Settlement Costs and Helpful Information," is also available through the Internet.

[113] As a practical matter, for loan applications taken face-to-face, this is already a common practice. For applications taken electronically or by mail or telephone, they may be mailed to the consumer within three days after application. They could be sent even sooner, but there would still be some delay before receipt.

the model for a similar publication that would be given to all applicants for nonpurchase loans. Information booklets on home-equity loans could inform consumers about common creditor abuses and could explain the advantages of reverse mortgages for some elderly consumers with limited incomes.[114] Consumers could also be educated about the impact of frequent refinancings on consumers' borrowing costs and how the repeated payment of up-front loan fees may increase consumers' total costs even if their monthly payments decline.

B. Harmonizing Coverage under TILA and RESPA

TILA and RESPA both cover consumer mortgage credit, but they differ in the types of transactions and parties covered. TILA's mortgage lending requirements apply to loans made by creditors that "regularly" (more than five times a year) extend consumer credit secured by a "dwelling," whether or not it is attached to real property. RESPA applies to all "federally related mortgage loans," defined generally as transactions secured by residential real property on which a structure is or will be located. In addition to requiring disclosures of specific loan information, RESPA also regulates certain payments and arrangements involving settlement service providers (realtors, title companies, and creditors).

Because of the inconsistencies in coverage, consumers obtaining mortgage credit do not always receive both TILA and RESPA disclosures in a given transaction. For example, a consumer purchasing a manufactured home that will be placed on rented land would receive a TILA disclosure but no RESPA disclosures. And yet, the disclosures seem helpful to all consumers seeking home-secured credit. For creditors, the inconsistencies in coverage add to the complexity and burden of the regulatory structure. Therefore, the agencies recommend that the Congress adopt a common coverage standard under both statutes for mortgage transactions.[115]

1. Mortgage Transactions Covered. TILA's mortgage lending requirements apply to transactions secured by a "dwelling," defined as a residential structure that contains one to four family housing units. The structure need not be attached to real estate. RESPA generally covers any loan secured by real property on which a residential structure is or will be located using the proceeds from the loan. RESPA disclosures are required for credit

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[114] Similarly, a booklet about refinancings could help consumers understand the costs involved in such transactions and aid them in determining the relative value of a decreased interest rates and smaller monthly payments compared with pre-paid refinancing costs or prepayment penalties. The Board, in consultation with other banking agencies and industry groups, publishes booklets on home refinancing ("Consumer's Guide to Mortgage Refinancing") and home-equity lines of credit ("When Your Home is on the Line"); only the latter is required to be provided by creditors.

[115] A minimal approach could harmonize TILA and RESPA disclosures by providing a coordinated disclosure where coverage currently overlaps. However, the acts' definitions are complicated and determining where coverage overlaps can be difficult. Amending the statutes to provide for consistency in the credit transactions covered and the parties responsible for providing disclosures seems the better approach.

Issues Concerning the Home Ownership Equity and Protection Act of 1994

In June 1997, the Board held hearings on the home-equity market, and on the effectiveness of the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act of 1994 (HOEPA), in protecting the rights of consumers, particularly low- and moderate-income consumers. HOEPA applies to certain home-secured loans with rates or fees above a certain amount.[1] HOEPA layers disclosure and timing requirements onto the requirements already imposed under TILA for closed-end mortgage loans. It also imposes contractual limitations on creditors offering HOEPA-covered loans. This report discusses the content of HOEPA disclosures in chapter 2, the timing of disclosures in chapter 4, and substantive protections and enforcement in chapter 6. Issues raised at the hearings concerning coverage, liability concerns, exemptions, and rulewriting authority are summarized below.

A. *Coverage*

1. Open-end Home-secured Transactions. HOEPA's "high-cost mortgage" provisions do not apply to all home-secured credit transactions. For example, home-purchase loans are exempt. Reverse mortgages are also exempt (but are subject to an alternative detailed disclosure scheme).[2]

Open-end lines of credit are also exempt from HOEPA's "high-cost mortgage" provisions. However, at the same time it enacted HOEPA, the Congress asked the Board to study whether the existing TILA rules provide adequate protections for consumers obtaining home-equity lines of credit. In November 1996, the Board reported to the Congress that adequate protections exist and that there was no evidence at that time to support the belief that excluding lines of credit from HOEPA encourages creditors to offer open-end home-

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[1] The rate-based test for a HOEPA-covered loan is met if the APR at the time of consummation exceeds by more than 10 percentage points the yield on Treasury securities having a comparable maturity. The dollar-based test is met if the total points and fees exceed 8 percent of the loan amount or a certain dollar amount, whichever is greater. The dollar figure is adjusted annually; for 1998 it is $435.

[2] A reverse mortgage transaction is a loan secured by the equity in a home where the balance increases rather than decreases over time. Disbursements are made to homeowners--typically on a monthly basis and to the elderly--until the homeowner dies, moves permanently, or sells the home. A part of HOEPA established a new calculation under TILA to measure the cost of reverse mortgage credit. Creditors must disclose the projected total cost of the credit, expressed as a rate (the "total annual loan cost" rate, or "TALC"). Unlike the APR, which is based solely on costs characterized as finance charges, the TALC rate takes account of any equity or shared appreciation that the homeowner will owe the creditor contractually and all charges and costs, including the cost of an annuity the consumer purchases (if any). The reverse mortgage disclosures are a layer on other disclosure requirements under TILA, and creditors must disclose an APR in addition to providing TALC rates for the reverse mortgage disclosure. TILA currently requires creditors offering reverse mortgages to provide cost disclosures at least three days before loan consummation.

equity lines as a way of evading the act's stricter disclosure rules and limitations for closed-end home-equity loans.[3]

Views expressed at the 1997 public hearings and in written comments were mixed on whether HOEPA should continue to exclude from its coverage home-secured, open-end lines of credit. A primary characteristic of open-end (revolving) credit is that creditors contemplate consumers may borrow to the extent they repay existing debt. Consumer representatives were uniformly concerned about creditors that incorporate into their loan agreements terms that satisfy the TILA's tests for open-end credit, but administer the loan as closed-end credit. Consumer representatives reported seeing some, but not a great many, of these agreements. They believed it would be appropriate to extend the HOEPA's coverage to open-end loans. Some creditors making HOEPA-covered loans agreed; they saw no reason to distinguish between revolving and installment credit. Other creditors, however, believed additional regulation was unnecessary.

Anecdotal evidence suggests that some creditors may be refinancing home-secured installment credit with open-end credit lines; this is troubling, even if it is not widespread. There is merit to the argument that consumers entering into high-priced home-equity credit lines should receive the same protections as those entering into a HOEPA-covered installment loan. However, as a general matter, the Board does not favor additional regulation where adequate protections exists. On balance, it seems premature to recommend extending HOEPA coverage to open-end credit.[4]

2. *Fees-based Test.* There is general consensus that HOEPA's fees-based test is complicated. HOEPA covers loans if the total fees payable by the consumer at or before loan closing exceed the greater of a set dollar amount or 8 percent of the loan amount. (The dollar figure is CPI-adjusted annually; for 1998, it is $435.) Fees included in the calculation include all compensation paid by consumers to brokers, "finance charges" (other than interest) such as points or origination fees, and closing costs such as appraisals that are paid to the creditor or the creditor's affiliate. Complaints were raised at the hearings about each component.

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[3] Board of Governors of the Federal Reserve System, Rules on Home-Equity Credit under the Truth in Lending Act, November 1996 (Board of Governors, 1996). *See* Board of Governors of the Federal Reserve System, *supra* note 13, at app. B.

[4] If the Congress determines that HOEPA coverage should be extended to open-end home-secured plans, the rate- and fees-based tests should be modified for these loans. For example, the rate-based test for closed-end mortgages is based on an APR that includes interest and other fees such as discount points and origination fees; the APR for open-end plans includes interest only. Also, the fees-based test is currently triggered by the amount of fees in relation to the "loan amount;" under an open-end plan, the amount of credit actually obtained is unknown at the time the account is opened.

Consumer representatives believe the fees-based test should include broker compensation paid by the creditor to the broker because consumers fund the payment through increased points or interest rates. Creditors, on the other hand, believe that broker costs paid indirectly by the consumer are captured by HOEPA's tests.

Broker representatives expressed concern about complying with the affiliate-closing cost component. One representative explained the complexity of the rule that requires brokers to know what affiliated business relationships the potential creditor may have as well as which fees that creditor or its affiliate will retain.

The largest source of compliance frustration in calculating the fees-based test, however, touches both the closing cost and "finance charge" components. As discussed in chapter 2, most closing costs associated with real estate-secured loans are excluded from TILA's finance charge. National creditors noted that fees vary in their service and name; the diversity makes it difficult for lenders to determine with certainty whether a fee is properly characterized as a finance charge and included in the fees-based test, or a closing cost that may be excluded.

There was broad agreement that HOEPA's fees-based test should be simplified, for example, by including all costs paid by the consumer at closing, irrespective of their characterization for other purposes under TILA. However, creditors and consumer representatives disagree whether "all costs" should include optional credit life insurance purchased by the consumer and the extent to which an all-cost approach merits a corresponding increase in the current 8 percent trigger, if any.[5]

Calculating the fee-based trigger is one of creditors' greatest compliance concerns under HOEPA. The rule appears straightforward--the loan is covered if closing costs exceed the greater of 8 percentage points of the loan amount or $435 (in 1998). However, the calculation is complex. TILA's "some fees in, some fees out" approach to characterizing fees as finance charges is part of the problem. The calculation becomes more complicated for brokers that submit loan applications to several creditors and must determine whether certain closing costs will be paid to the creditor or affiliate (included in the fees-based test) or to an unaffiliated third party (excluded from the test).

Modifying the TILA's finance charge would simplify HOEPA's fees-based test. Alternatively, the fees-based test could be simplified to include all costs paid at closing,

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[5] Creditors oppose including the premiums for optional credit life insurance in the fees test, believing the choice to purchase insurance is a separate decision made by the consumer. However, consumer representatives champion the inclusion of credit life premiums in the fees test. They argue that HOEPA-loan recipients often do not understand that the loan could be funded without purchasing credit insurance. More fundamentally, they believe the premium is a cost payable at closing and should be included.

without regard to whether the fee is a finance charge or paid to the creditor (or its affiliate) or an unaffiliated third party. If the Congress simplifies the fees-based test by adding more or all closing costs (including changing TILA's finance charge definition), the number of HOEPA-covered loans could increase; the Congress may wish to consider whether it would be appropriate to adjust the 8 percentage point and fee trigger.

B. Liability Concerns

Failure to comply with HOEPA may result in significant losses to the creditor and subsequent purchasers of the loan. Consumers entering into a HOEPA-covered loan may rescind the transaction for up to three years after closing if creditors fail to provide the special HOEPA disclosures or if they include a prohibited term in the loan agreement. Creditors--and any subsequent assignee--face civil money penalties equal to all finance charges and fees paid by the consumer.

1. Correcting Errors. Creditors are concerned about the lack of clear guidance in TILA about how to correct, after the loan is consummated, an error made in connection with a HOEPA disclosure. For example, a creditor may learn in a post-consummation audit that the rate or fees charged for the loan were high enough to trigger HOEPA rules, and that HOEPA disclosures should have been provided. Although TILA addresses actions creditors may take when they discover an error in a disclosure being provided at the loan closing, creditors are concerned that a court might determine that this provision is inadequate for curing a HOEPA disclosure violation when the creditor cannot go back in time (in the case of a disclosure that had to be given before closing). Investors holding large portfolios of HOEPA loans are concerned about exposure to loss and whether errors in HOEPA disclosures discovered after closing can be cured.

The Board believes that a procedure for lenders to correct HOEPA disclosure errors discovered after consummation should be considered. The process could be similar to TILA's current provisions, permitting creditors to provide an accurate version of the disclosures and allowing consumers an additional period to rescind the transaction.

2. Assignee Liability. Consumer representatives applaud HOEPA's extension of liability to subsequent purchasers and believe it to be a necessary curb against abusive lending practices. Creditors believe the additional liability has a chilling effect on creditors and investors alike, neither wanting the potential exposure for liability. Creditors advocate eliminating assignee liability altogether.

The Board is not recommending that HOEPA's assignee liability provisions be eliminated. Testimony indicates that while the provisions may have a chilling effect on some creditors and investors, the capital markets and other investors are willing to assume the risk associated with HOEPA-covered loans in securitization and other loan-purchase programs.

These provisions encourage those funding HOEPA-covered loans to monitor the practices of those closing the loan; evidence of continuing abuses despite these safeguards suggests the assignee provisions should remain.

C. Exemptions

HOEPA authorizes the Board to exempt specific mortgage products or categories of mortgages from some or all of HOEPA's prohibitions. Many of those testifying at the Board's hearings believed no exemptions were appropriate at this time. Others offered a variety of possible exemptions ranging from certain mortgage products (first lien loans) to particular creditors (small investors who are less likely to understand TILA's complex disclosure requirements). One creditor suggested exemptions for loans not the target of HOEPA such as if a consumer's debt-to-income ratio is below a certain percentage, such as 50 percent. The Board is not recommending any exemptions to HOEPA at this time, based on the comments received and its own analysis.

D. General Rulewriting Authority

HOEPA removes the Board's general rulewriting authority in implementing HOEPA. Many creditors believe that limitation should be eliminated. They believe that some compliance burdens under the statute could be reduced through the Board's authority to make classifications or create exceptions to facilitate compliance without diminishing consumer protections. The Congress may wish to reconsider its limitation on the Board's rulewriting authority for HOEPA-covered transactions. For example, chapter 2 of this report discusses possible improvements to the content of HOEPA's disclosures, based on comments and testimony received in connection with the Board's hearings: Greater flexibility through rulemaking and public comment could result in model clauses with more user-friendly messages for the text of "warnings" than is currently prescribed by the statute.